IRS Proposes Form 5472 Filing Duty for Foreign-Owned Disregarded Entities

By Hale E. Sheppard

I. Introduction

The U.S. government, fed up with international tax evasion, has taken significant steps in recent years to curb the problem. Among the most notorious of these steps was the enactment of the Foreign Account Tax Compliance Act (FATCA), which effectively forces foreign financial institutions to provide the IRS with valuable data about U.S. clients. International organizations have pointed out a flaw with these efforts: While occupied pressuring others to surrender client data, the U.S. government supposedly has failed to keep its own house in order. The major criticism is that, as a result of gaps in U.S. tax law, foreigners can easily hide money in the United States by utilizing a domestic, single-member, limited liability company, treated as a disregarded entity (DRE) for federal tax purposes. In an effort to halt this practice, the IRS issued proposed regulations in May 2016 ("Proposed Regulations") that would obligate foreign-owned, single-member, domestic DREs to file annual Forms 5472 (Information Return of a 25-percent-Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business) with the IRS. This article explores important aspects and consequences of the Proposed Regulations.

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II. Review of Current Law

To appreciate the changes introduced by the Proposed Regulations, one must first understand present law with respect to Form 5472 and the related record-keeping requirements. The current state of affairs is described below.

A. Brief History of Code Sec. 6038A and Code Sec. 6038C

Foreign investment and foreign business activity in the United States increased significantly in the 1980s. The U.S. government, through Congress and the IRS, began taking steps to ensure that these items were properly taxed and monitored. One example of these efforts was the enactment of Code Sec. 6038A in 1982. The

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primary purpose of that legislation was to gather additional information about foreigners to prevent the manipulation of related-party transactions and the resulting decrease in U.S. tax liabilities.[1] The congressional rationale for passing Code Sec. 6038A was the following:

> Transactions between related parties are required to be at arms-length prices. This rule applies, for example, to transactions between a U.S. parent and its foreign subsidiaries, as well as to transactions between a foreign parent and its U.S. subsidiaries. Under prior law, a U.S. parent corporation was required to report transactions with its foreign affiliates and transactions between its foreign affiliates, but no such reporting was required of transactions between a U.S. subsidiary of a foreign corporation and its foreign affiliates. Consequently, the existence of such transactions did not necessarily come to the attention of the Internal Revenue Service. Congress believes that a requirement that such transactions be reported will reduce transfer price abuses and similar abuses and will place foreign controlled U.S. entities on equal footing with U.S. corporations controlled by U.S. persons.[2]

Code Sec. 6038A originally applied to domestic corporations with significant ownership by foreign persons. It was later expanded to cover foreign corporations engaged in a trade or business in the United States, irrespective of the percentage of foreign ownership.[3] In 1990, Congress enacted Code Sec. 6038C, which essentially split the two requirements: Domestic corporations that were foreign-owned would be governed by Code Sec. 6038A, while foreign corporations with U.S. operations would be controlled by Code Sec. 6038C.[4] Despite this statutory separation, the two tax provisions share the same regulations (*i.e.*, those under Code Sec. 6038A), and corporations subject to either provision must supply the IRS with information each year in the same manner (*i.e.*, on Form 5472).

B. Analysis of Key Concepts

Form 5472 generally must be filed by a "reporting corporation" in order to disclose to the IRS certain "reportable transactions" between it and "related parties." Thus, taxpayers must analyze each of these three concepts to determine if they must file Forms 5472. These concepts are terribly complicated and technical, even for tax professionals, and a detailed discussion is beyond the scope of this article. However, having a general understanding of the three key terms is important. They are summarized below.

1. What Is a "Reporting Corporation?"

The filing obligations are created by two interrelated tax provisions.

Under Code Sec. 6038A, a "reporting corporation" is a *domestic corporation* that is at least 25-percent-foreign-owned.[5] A domestic corporation is considered to be a 25-percent-foreign-owned corporation for these purposes if at least 25 percent of its stock is owned, either directly or indirectly, by one foreign person at any time during the relevant tax year.[6] This foreign person is commonly known as the "25-percent-foreign shareholder." In this context, "foreign persons" include an individual who is not a U.S. citizen or U.S. resident, an individual who is a citizen of a U.S. possession, a foreign government and any partnership, association, company, corporation, trust or estate that is not domestic.[7]

According to Code Sec. 6038C, a "reporting corporation" is also any *foreign corporation* that operates a U.S. trade or business at any time during the year at issue.[8] The regulations clarify that if a foreign corporation is a resident of a foreign country that has a tax treaty with the United States, then it will not be considered a "reporting corporation," unless it has a so-called permanent establishment in the United States.[9]

2. What Is a "Reportable Transaction?"

The term "reportable transaction" encompasses several items, including, but not limited to, sales and purchases of inventory and other tangible property, rents and royalties paid and received, consideration paid for use of all intangible property, consideration paid for services rendered (including technical, managerial, engineering, construction, scientific and others), commissions paid and received, certain amounts loaned or borrowed, interest paid or received, premiums received for insurance or reinsurance and the catch-all, other amounts paid to or received from related parties that are taken into account in determining the taxable income of the reporting corporation.[10]

One notable exception exists. A transaction is not considered a "reportable transaction" (and thus not required to be reported on Form 5472) if (i) neither the reporting corporation nor the related party is a U.S. person; (ii) the transaction will not generate in any year gross income from U.S. sources or income effectively connected with a U.S. trade or business; and (iii) the transaction will not generate in any year any expenses, losses or other deductions that could be allocated or apportioned to such income.[11]

3. What Is a "Related Party?"

A "related party" is broadly defined to cover (i) any 25-percent-foreign-shareholder of the reporting corporation, (ii)

any person who is related to the 25-percent-foreign-shareholder according to certain ownership-attribution rules, (iii) any person who is related to the reporting corporation under the same ownership-attribution rules and (iv) any entity that is owned or controlled by the same persons as the reporting corporation pursuant to the transfer-pricing rules in Code Sec. 482.[12] The term "related party" does not include any corporation filing a consolidated federal income tax return with the reporting corporation.[13]

C. Form 5472 Filing Requirement

A reporting corporation must file a *separate* annual Form 5472 with respect to *each* related party with which it had any reportable transaction during the relevant year.[14] This, of course, opens the door for taxpayers to incur numerous penalties in one year. Notably, Forms 5472 must be filed with the IRS, even though the information they contain may not affect the amount of U.S. tax due.[15] When, where and how a reporting corporation files Forms 5472 has changed numerous times over the years, and new rules are still pending. The most recent versions of the filing rules are discussed later in this article.

D. Record-Keeping Requirement

In addition to filing Forms 5472, a reporting corporation must also maintain records of reportable transactions in sufficient detail to establish the correct tax treatment of the transactions.[16] These records must be kept as long as they may be relevant or material to determining such treatment, and they must generally be kept within the United States.[17]

There are exceptions to this special record-keeping requirement in cases of small reporting corporations (*i.e.*, those that have less than $10 million in U.S. gross receipts for a tax year) and small reportable transactions (*i.e.*, where the aggregate value of all gross payments a reporting corporation makes to and receives from foreign-related parties during a tax year does not exceed $5 million and is less than 10 percent of the reporting corporation's U.S. gross income).[18] However, neither of these two record-keeping exceptions relieves a reporting corporation from its obligation to file annual Forms 5472.[19] In other words, while the IRS liberates certain small items from the extra record-keeping burden, it still demands reporting of relevant transactions on Forms 5472.

E. Penalties for Form 5472 Violations

A reporting corporation that fails to file timely Forms 5472 is subject to civil penalties.[20] Likewise, a reporting corporation that files timely, yet "substantially incomplete," Forms 5472 will be punished.[21] The IRS generally may impose a penalty of $10,000 for each violation for each year, which can add-up quickly if a reporting corporation fails to file multiple Forms 5472 for an extended period.[22]

This penalty increases where the failure to file Forms 5472 continues after the IRS notifies the reporting corporation of its noncompliance. Specifically, if the reporting corporation fails to supply to the IRS the missing Forms 5472 within 90 days of notice from the IRS, then the penalty increases by $10,000 each additional month.[23]

F. Exceptions to Penalties and Special Rules

The regulations contain some unique rules regarding penalty mitigation.

1. First Exception—Reasonable Cause Defense

If the reporting corporation acted in "good faith" and there is "reasonable cause" for not filing a Form 5472 or maintaining proper records, then the initial $10,000 penalty may be waived, and the running of the 90-day correction period may be tolled.[24] The reporting corporation must make an affirmative showing of all the relevant facts in a written statement made under penalties of perjury to demonstrate that good faith and reasonable cause exist.[25]

The IRS makes its determination of whether the reporting corporation acted reasonably and in good faith on a case-by-case basis, taking into account all the pertinent facts and circumstances.[26] The regulations provide the following guidance in this regard: (i) An honest misunderstanding of fact or law by the reporting corporation may indicate reasonable cause and good faith in light of the experience and knowledge of the reporting corporation. (ii) Isolated computational or transcriptional errors are consistent with reasonable cause and good faith. (iii) Reliance by the reporting corporation on an erroneous information return, erroneous professional advice or other erroneous data constitutes reasonable cause and good faith, only if such reliance was reasonable under all the circumstances. (iv) A reporting corporation may have grounds for penalty abatement if it has a reasonable belief (*i.e.*, it does not know or have reason to know) that it is not owned by a 25-percent-foreign-shareholder. (v) Reasonable cause may exist in situations where a foreign owner is considered a "related party" solely under the broad principles of the transfer-pricing rules in Code Sec. 482, and the reporting corporation had a reasonable belief that its relationship with the foreign owner did not meet these broad principles.[27]

2. Second Exception—Substantial Compliance Defense

The regulations also contemplate a "substantial compliance" defense to penalties, which is categorized as a subset of "reasonable cause." This defense only applies if the reporting corporation filed a timely Form 5472, but it was incomplete or inaccurate.[28] Upon introducing this defense in the earliest regulations, the IRS envisioned salvation for many taxpayers: "The [IRS] anticipates that the broad range of estimates and descriptions allowed in [the Code Sec. 6038A regulations] will prevent most inadvertent errors from causing a technical violation if the reporting corporation has made a reasonable effort to comply."[29]

3. Third Exception—Reasonable Estimates Defense

The regulations provide flexibility in terms of the figures reported on Forms 5472, allowing latitude of 25 percent on either side. In this regard, the regulations state that "[a]ny amount reported [on Form 5472] is considered to be a reasonable estimate if it is at least 75 percent and not more than 125 percent of the actual amount."[30] Adding yet more flexibility, the regulations go on to clarify that, even if the "reasonable estimate test" described above is not met, the reporting corporation may nevertheless prove that amount was reasonable (and thus no penalties should be imposed) by submitting a statement explaining the relevant facts and circumstances.[31]

4. Fourth Exception—Small Amounts Defense

The regulations explain that, if any actual amount required to be reported does not exceed $50,000, then simply stating this on Form 5472 suffices. Reporting corporations are directed to write "$50,000 or less" in the pertinent places.[32]

5. Fifth Exception—Small Reportable Corporation Defense

The IRS must "liberally" apply the reasonable-cause-and-good-faith exception in cases where four factors are met: The reporting corporation (i) is a small corporation, *i.e.*, its gross receipts for the relevant year are $20 million or less; (ii) had no knowledge of the duty to file Form 5472 and/or maintain special records; (iii) has a limited presence in and contact with the United States; and (iv) promptly and fully complies with all requests by the IRS to file Forms 5472, and to furnish books, records or other materials relevant to reportable transactions.[33]

III. Rationale for Changes in 2016—Proposed Regulations

A. Data Received (or Not) from Foreign Persons—Current Situation

The IRS normally has a good deal of information about foreign persons who invest in or conduct business in the United States, either individually or through an entity, because they must file annual income tax returns with the IRS. For example, a foreign corporation engaged in a U.S. trade or business generally files a Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation,* enclosing a Form 5472, domestic corporations with significant foreign ownership file a Form 1120, *U.S. Corporation Income Tax Return*, enclosing a Form 5472, a partnership, whether foreign or domestic, files a Form 1065, *U.S. Return of Partnership Income*, revealing information about the partners/owners on the enclosed Schedules K-1, *Partner's Share of Income, Deductions, Credits, etc.*, and noncitizen–nonresidents file a Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*, if they are engaged in a U.S. trade or business or have certain types of income from U.S. sources.

In addition to the data derived from income tax returns, the IRS obtains information about foreign persons because they often file a Form 8832, *Entity Classification Election*, indicating to the IRS how they intend to be treated for U.S. tax purposes and/or a Form SS-4, *Application for Employer Identification Number*, to secure their identities with the IRS, their Employer Identification Numbers (EINs). In the case of an entity, the name and identifying number of the owner must be provided to the IRS on Form 8832. The IRS's Instructions to Form 8832 explain the following regarding one-owner entities:

> If an eligible entity has only one owner, provide the name of its owner on line 4a and the owner's identifying number (social security number, or individual taxpayer identification number, or EIN) on line 4b. If the electing eligible entity is owned by an entity that is a disregarded entity or by an entity that is a member of a series of tiered disregarded entities, identify the first entity (the entity closest to the electing eligible entity) that is not a disregarded entity. For example, if the electing eligible entity is owned by disregarded entity A, which is owned by another disregarded entity B, and disregarded entity B is owned by partnership C, provide the name and EIN of partnership C as the owner of the electing eligible entity.[34]

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Like Form 8832, Form SS-4 requires data about the ultimate owner of the person seeking the EIN. It does so by demanding information about the "responsible party." The IRS's Instructions to Form SS-4 provide the following guidance about this requirement:

> Lines 7a–b. Name of responsible party. Enter the full name (first name, middle initial, last name, if applicable) and SSN, ITIN, or EIN of the entity's responsible party, as defined later.
>
> Responsible party defined … For all other entities [*i.e.*, all entities other than those whose interests or shares are traded on a public exchange, which are registered with the Securities and Exchange Commission, or which are government entities], the "responsible party" is the individual who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets. The ability to fund the entity or the entitlement to the property of the entity alone, however, without any corresponding authority to control, manage, or direct the entity (such as in the case of a minor child beneficiary), doesn't cause the individual to be a responsible party.[35]

Currently, neither Form 8832 nor Form SS-4 is required to be filed in certain situations involving DREs. The Instructions to Form 8832 state that a "new eligible entity should not file Form 8832 if it will be using its default classification," which, in the case of an entity with one owner, is a DRE.[36] Similarly, the current Instructions to Form SS-4 explain that a DRE only needs to file a Form SS-4 if it needs an EIN to pay employment or excise taxes, to comply with a nonfederal tax requirement (such as a state mandate), to file a Form 8832 to elect to be treated as an association/corporation instead of a DRE, or because it has acquired one or more additional owners, thereby changing its classification from a DRE to a partnership under the default rules.[37]

B. Reasons for Issuing Proposed Regulations

With that backdrop, we now move to the supposed problems, the reason for creating the Proposed Regulations forcing foreign-owned, single-member, domestic DREs to file Forms 5472. The IRS identifies the following issues in the Preamble to the Proposed Regulations:

- The entity-classification regulations, also known as the check-the-box regulations, located in Reg. §301.7701-1 through Reg. §301.7701-3, contain default rules that function to treat entities with just one owner as DREs, unless they file a Form 8832 with the IRS electing to be treated as an association/corporation for U.S. tax purposes.
- Many of these DREs consist of domestic limited liability companies owned by one foreign person.
- Persons forming DREs in certain states are required to provide little, if any, information about the ultimate owner.
- As explained above, the current rules do not require the filing by a DRE of a Form 8832 (because it is accepting the default classification as a DRE) or a Form SS-4 (because it does not need to obtain an EIN).
- In situations where neither the DRE nor its owner received any U.S.-source income during a tax year and was not engaged in a U.S. trade or business during a tax year, no U.S. income tax returns are required to be filed.
- If a DRE receives only certain types of U.S.-source income, such as portfolio/investment interest or U.S.-source income that is subject to automatic tax withholding, the owner of the DRE might not be obligated to file a U.S. tax return.
- The current lack of U.S. filing and record-keeping requirements for certain foreign-owned, single-member, domestic DREs makes it difficult for the IRS to ascertain whether a DRE or its owner is liable for any U.S. taxes and hinders the ability of the U.S. government to comply with international standards concerning financial transparency and tax enforcement.
- The current weaknesses triggered by the U.S. tax rules have been highlighted by various organizations, including the Financial Action Task Force and the Global Forum on Transparency and Exchange of Information for Tax Purposes.[38]

The criticisms launched by the international organizations have been echoed by a number of respected publications, including FINANCIAL TIMES, FORBES, BUSINESS WEEK and THE ECONOMIST. They have all recently released articles addressing the inadequacy of current disclosure requirements and the hypocrisy of the United States in pressuring foreign countries and financial institutions to implement FATCA, while the United States has still not enacted the Common Reporting Standard, an international tax-information exchange initiative overseen by the Organization for Economic Cooperation and Development.[39] These articles refer to the United States as "the biggest tax haven in the world," "the new Switzerland," "a black hole of information for other countries" and "the

biggest tax loophole of all."[40] In addition to the media, major accounting firms have underscored the fact that certain elements are now labeling the United States a "tax haven" because of the ability of taxpayers to conceal their identities and activities through the use of foreign-owned, single-member, domestic DREs.[41] In light of this reality, the IRS issued the Proposed Regulations in May 2016. Their purpose is "to provide the IRS with improved access to information that it needs to satisfy obligations under U.S. tax treaties, tax information exchange agreements and similar international agreements, as well as to strengthen the enforcement of U.S. tax laws."[42]

As explained in detail below, the main effects of the Proposed Regulations are the following: (i) Foreign-owned, single-member, domestic DREs would be treated as "domestic corporations" (and thus "reporting corporations") *solely* for purposes of Code Sec. 6038A. (ii) As reporting corporations, these entities would be required to file annual Forms 5472 and comply with the rigid record-keeping requirements. (iii) Because the entities will now have a filing requirement with the IRS (*i.e.*, Form 5472), they must also file a Form SS-4 (giving the IRS information about the "responsible person") in order to obtain an EIN. (iv) The types of "reportable transactions" that must be disclosed on Form 5472 would be expanded. (v) Certain exceptions to the strict record-keeping requirements (normally shielding corporations with small gross incomes and/or small reportable transactions) would not be available to help foreign-owned, single-member, domestic DREs. The Proposed Regulations recognize that the new filing requirements may cause some duplicative filings by taxpayers, and the IRS is fine with that: The IRS acknowledges that the Proposed Regulations "would impose a filing obligation on a foreign-owned disregarded entity for reportable transactions it engages in even if its foreign owner already has an obligation to report the income resulting from those transactions—for example, transactions resulting in income effectively connected with the conduct of a U.S. trade or business."[43]

Regardless of the outcome, all taxpayers potentially subject to Form 5472 duties (i.e., domestic corporations that are least 25-percent foreign-owned, foreign corporations operating a U.S. trade or business, and, soon, foreign-owned, single-member, domestic DREs) should retain specialized U.S. tax professionals to advise on these complex, dynamic issues.

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The IRS and the White House, of course, made several announcements in connection with the issuance of the Proposed Regulations and certain other measures aimed at strengthening international enforcement. One such announcement, which has been reworked and released elsewhere, is set forth below. It derives from a "Fact Sheet" issued by the White House in May 2016, in the segment called "Closing A Loophole that Enables Foreigners to Hide Behind Anonymous Entities Formed in the United States."

> The Treasury Department and Internal Revenue Service (IRS) are issuing proposed regulations closing a loophole in U.S. laws that has allowed foreigners to hide assets or financial activity behind anonymous entities established in the United States. The rule will require foreign-owned entities that are "disregarded entities" for tax purposes, including foreign-owned single-member limited liability companies (LLCs), to obtain an employer identification number (EIN) with the IRS. These entities represent a narrow class of foreign-owned U.S. entities that have previously had no obligation to report information to the IRS or to get a tax identification number, and thus can be used to shield the foreign owners of non-U.S. assets or non-U.S. bank accounts. The proposed rule will strengthen the IRS's ability to prevent the use of these entities for tax avoidance purposes, and will build on the success of other efforts to curb the use of foreign entities and accounts to evade U.S. tax.[44]

IV. Description of the Proposed Regulations

The IRS intends to modify three existing regulations (*i.e.*, Reg. §301.7701-2, Reg. §1.6038A-1 and Reg. §1.6038A-2) in order to implement the changes affecting foreign-owned, single-member, domestic DREs and Form 5472. One of the biggest challenges in understanding regulatory modifications, like the ones here, is that often they are not adequately described. Indeed, the IRS's normal methodology is to identify a long, complicated regulation and then provide mere snippets of information

to explain what will be deleted, added or altered. This makes it difficult to get the whole picture, which cynics might say is the IRS's intention. In an effort to ensure that the issues are clear with respect to Form 5472, this portion of the article provides textual comparisons and other background information.

A. Proposed Changes to Reg. §301.7701-2

As explained above, Reg. §301.7701-2 is part of the entity-selection regulations, which are also known as the check-the-box regulations. Together, this set of regulations provides that a business entity with just one owner can choose to be treated for federal tax purposes as either an association/corporation or a DRE, as long as such entity is not forced to be classified as a corporation under the "per se corporation" rules.[45] Generally, if a domestic eligible entity with just one owner does not file a timely Form 8832, *Entity Classification Election*, then the IRS will consider it a DRE by default.[46] The Proposed Regulations contemplate changing Reg. §301.7701-2 in the following three ways.

1. Revising Last Sentence of Reg. §301.7701-2(a)

Reg. §301.7701-2(a) contains introductory information about the federal tax treatment of business entities. It states the following in its present form:

> [A] business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. But see [Reg. §301.7701-2(c)(2)(iv) through (v)] for special employment and excise tax rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.

The Proposed Regulations intend to make a minor change, a slight tweak to the last sentence in order to reference the substantive change in Reg. §301.7701-2(c)(2)(vi), discussed below. If the Proposed Regulations were to be finalized in their current form, then Reg. §301.7701-2(a) would state the following. The modified sentence is italicized for the convenience of the reader.

> [A] business entity is any entity recognized for federal tax purposes (including an entity with a single owner that may be disregarded as an entity separate from its owner under §301.7701-3) that is not properly classified as a trust under §301.7701-4 or otherwise subject to special treatment under the Internal Revenue Code. A business entity with two or more members is classified for federal tax purposes as either a corporation or a partnership. A business entity with only one owner is classified as a corporation or is disregarded; if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner. *But see [Reg. §301.7701-2 (c)(2)(iii) through (vi)] for special rules that apply to an eligible entity that is otherwise disregarded as an entity separate from its owner.*

2. Adding Reg. §301.7701-2(c)(2)(vi)

Reg. §301.7701-2(c)(2) contains the rules regarding one-owner-entities. It is currently divided into five parts, separately addressing the general classification standard, an exception for certain banks, parameters on the scope of disregarded status, special rules for employment tax purposes and more special rules for excise tax purposes.

The Proposed Regulations would retain the existing five parts and then add one more special rule, this one related to information-reporting under Code Sec. 6038A. Specifically, the Proposed Regulations would create Reg. §301.7701-2(c)(2)(vi), which generally states that an entity that is treated as a DRE under the entity-selection regulations will be "*classified as a corporation for purposes of Section 6038A*" if (i) the entity is domestic and (ii) one foreign person has direct sole ownership of the entity or indirect sole ownership of the entity.[47] For these purposes, the concept of "indirect sole ownership" means ownership by one person entirely through one or more entities disregarded as separate from their owners or through grantor trusts, regardless of whether any such disregarded entity/entities or grantor trusts is domestic or foreign.[48]

3. Adding Reg. §301.7701-2(e)(9)

The applicability/effective date of the entity-selection regulations, or check-the-box regulations, is found in Reg. §301.7701-2(e). The Proposed Regulations add Reg. §301.7701-2(e)(9), which says that the new Form 5472 reporting requirement for foreign-owned, single-member, domestic DREs applies to tax years ending on or after the date that is 12 months after the date that the Proposed Regulations are finalized *via* publication in the Federal Register.

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B. Proposed Changes to Reg. §1.6038A-1

The Proposed Regulations make several changes to Reg. §1.6038A-1, which explains the general requirements and definitions concerning Form 5472. The changes are examined below.

1. Adding Sentence to Reg. §1.6038A-1(c)(1)

Reg. §1.6038A-1(c)(1), which contains the definition of "reporting corporation," currently states the following:

> For purposes of section 6038A, a reporting corporation is either a domestic corporation that is 25-percent foreign-owned as defined in [Reg. §1.6038A-1(c)(2)], or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation. See section 6038C.

The Proposed Regulations would add one sentence to the end, cross-referencing the entity-selection regulations and clarifying that foreign-owned, single-member, domestic DREs would be treated as "domestic corporations" (and thus "reporting corporations") for purposes of Code Sec. 6038A. The updated version of Reg. §1.6038A-1(c)(1) reads as follows. The new language has been italicized for ease of review.

> For purposes of section 6038A, a reporting corporation is either a domestic corporation that is 25-percent foreign-owned as defined in [Reg. §1.6038A-1(c)(2)], or a foreign corporation that is 25-percent foreign-owned and engaged in trade or business within the United States. After November 4, 1990, a foreign corporation engaged in a trade or business within the United States at any time during a taxable year is a reporting corporation. See section 6038C. *A domestic business entity that is wholly owned by one foreign person and that is otherwise classified under [Reg. §301.7701-3(b)(1)(ii)] as disregarded as an entity separate from its owner is treated as an entity separate from its owner and classified as a domestic corporation for purposes of section 6038A. See [Reg §301.7701-2(c)(2)(vi)].*

2. Revising First Sentence of Reg. §1.6038A-1(h)

As explained earlier in this article, in addition to filing Forms 5472, a reporting corporation must maintain records of reportable transactions in sufficient detail to establish the correct tax treatment of the transactions.[49] These records ordinarily must be kept as long as they may be relevant or material to determining such treatment, and they must generally be kept within the United States.[50] As also explained earlier in this article, there is an exception to this record-keeping rule in Reg. §1.6038A-1(h) for small reporting corporations, *i.e.*, those that have less than $10 million in U.S. gross receipts for a tax year. Reg. §1.6038A-1(h) currently states the following:

> A reporting corporation that has less than $10,000,000 in U.S. gross receipts for a taxable year is not subject to [the special record-keeping requirements set forth in Reg. §1.6038A-3 and Reg. §1.6038A-5] for that taxable year. Such a corporation, however, remains subject to the information reporting requirements of [Reg. §1.6038A-2] and the general record maintenance requirements of Section 6001 … .

The Proposed Regulations serve to make foreign-owned, single-member, domestic DREs ineligible for this small corporation exception, such that they would be required to file Forms 5472 and maintain detailed records of reportable transactions within the United States. The updated language, italicized for clarity, would be as follows.

> A reporting corporation *(other than an entity that is treated as a reporting corporation by reason of §301.7701-2(c)(2)(vi) of this chapter)* that has less than $10,000,000 in U.S. gross receipts for a taxable year is not subject to [the special record-keeping requirements set forth in Reg. §1.6038A-3 and Reg. §1.6038A-5] for that taxable year. Such a corporation, however, remains subject to the information reporting requirements of [Reg. §1.6038A-2] and the general record maintenance requirements of Section 6001 … .

3. Revising First Sentence of Reg. §1.6038A-1(i)(1)

It is not only small reporting corporations that get a break from the special record-keeping requirements under current law; corporations with small reportable transactions are relieved, too. Reg. §1.6038A-1(i)(1) currently states the following:

> A reporting corporation is not subject to [the special record-keeping requirements set forth in Reg. §1.6038A-3 and Reg. §1.6038A-5] for any taxable year in which the aggregate value of all gross payments it makes to and receives from foreign related parties with respect to related party transactions (including monetary consideration,

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nonmonetary consideration, and the value of transactions involving less than full consideration), is not more than $5,000,000 and is less than 10 percent of its U.S. gross income. Such a corporation, however, remains subject to the information reporting requirements of [Reg. §1.6038A-2] and the general record maintenance requirements of section 6001 … .

The waiver for small reportable transactions will also disappear if the Proposed Regulations are finalized in their current state. The new language is described below, with the changes italicized for emphasis.

> A reporting corporation *(other than an entity that is treated as a reporting corporation by reason of §301.7701-2(c)(2)(vi) of this chapter)* is not subject to [the special record-keeping requirements set forth in Reg. §1.6038A-3 and Reg. §1.6038A-5] for any taxable year in which the aggregate value of all gross payments it makes to and receives from foreign related parties with respect to related party transactions (including monetary consideration, nonmonetary consideration, and the value of transactions involving less than full consideration), is not more than $5,000,000 and is less than 10 percent of its U.S. gross income. Such a corporation, however, remains subject to the information reporting requirements of [Reg. §1.6038A-2] and the general record maintenance requirements of section 6001 … .

4. Adding New Sentence to Reg. §1.6038A-1(n)

Reg. §1.6038A-1(n)(1) contains the effective/applicability date for all matters required by Reg. §1.6038A-1, whereas Reg. §1.6038A-1(n)(2) does the same for all matters mandated by Reg. §1.6038A-2. The Proposed Regulations add one sentence to each of these provisions in order to make the new rules effective for future years. In particular, they state that all the new and/or modified rules in Reg. §1.6038A-1 and Reg. §1.6038A-2 "apply to tax years of [the relevant entities] ending on or after the date that is 12 months after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register."

C. Proposed Changes to Reg. §1.6038A-2

1. Adding New Paragraph to Reg. §1.6038A-2(b)(3)

Reg. §1.6038A-2(b)(3) currently features the list of 10 types of monetary transactions that must be reported on Form 5472. The Proposed Regulations would add another category of reportable transaction for foreign-owned, single-member, domestic DREs by inserting new Reg. §1.6038A-2(b)(3)(xi). It would obligate disclosure of the following matters:

> With respect to [a foreign-owned, single-member, domestic DRE] that is treated as a reporting corporation by reason of §301.7701-2(c)(2)(vi) of this chapter, any other transaction as defined by §1.482-1(i)(7), such as amounts paid or received in connection with the formation, dissolution, acquisition and disposition of the entity, including contributions to and distributions from the entity.

According to Reg. §1.482-1(i)(7), the term "transaction" is broadly defined to mean "any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented [and] a transaction also includes the performance of any services for the benefit of, or on behalf of, another taxpayer."

2. Adding New Reg. §1.6038A-2(b)(9)

The current regulations do not offer examples. These would be added by the Proposed Regulations, as the new Reg. §1.6038A-2(b)(9). It contains the following two items:

- **Example 1.** In year 1, W, a foreign corporation, forms and contributes assets to X, a domestic limited liability company that does not elect to be treated as a corporation under Reg. §301.7701-3(c) of this chapter. In year 2, W contributes funds to X. In year 3, X makes a payment to W. In year 4, X, in liquidation, distributes its assets to W. In accordance with Reg. §301.7701-3(b)(1)(ii) of this chapter, X is disregarded as an entity separate from W. In accordance with Reg. §301.7701-2(c)(2)(vi) of this chapter, X is treated as an entity separate from W and classified as a domestic corporation for purposes of Code Sec. 6038A. In accordance with paragraphs (a)(2) and (b)(3) of this section, each of the transactions in years 1 through 4 is a reportable transaction with respect to X. Therefore, X has a Code Sec. 6038A reporting and record maintenance requirement for each of those years.
- **Example 2.** The facts are the same as in Example 1 of this paragraph (b)(9) except that in year 1 W also forms and contributes assets to Y, another domestic limited liability company that does not elect to be treated as a corporation under Reg. §301.7701-3(c) of this chapter. In year 1, X and Y form and

contribute assets to Z, another domestic limited liability company that does not elect to be treated as a corporation under Reg. §301.7701-3(c) of this chapter. In year 2, X transfers funds to Z. In year 3, Z makes a payment to Y. In year 4, Z distributes its assets to X and Y in liquidation. In accordance with Reg. §301.7701-3(b)(1)(ii) of this chapter, Y and Z are disregarded as entities separate from each other, W, and X. In accordance with Reg. §301.7701-2(c)(2)(vi) of this chapter, Y, Z and X are treated as entities separate from each other and W and are classified as domestic corporations for purposes of Code Sec. 6038A. In accordance with paragraph (b)(3) of this section, each of the transactions in years 1 through 4 involving Z is a reportable transaction with respect to Z. Similarly, the contribution to Y in year 1, the payment to Y in year 3, and the distribution to Y in year 4 are reportable transactions with respect to Y. Moreover, X's funds transfer to Z in year 2 is a reportable transaction. Therefore, Z has a Code Sec. 6038A reporting and record maintenance requirement for years 1 through 4, Y has a Code Sec. 6038A reporting and record maintenance requirement for years 1, 3 and 4, and X has a Code Sec. 6038A reporting and record maintenance requirement in year 2 in addition to its Code Sec. 6038A reporting and record maintenance described in Example 1 of this paragraph (b)(9).

3. Adding Sentence to the End of Reg. §1.6038A-2(d)

Reg. §1.6038A-2(d) contains the rules regarding how and when to file Forms 5472. The current rule states that Forms 5472 "must be filed with the reporting corporation's income tax return for the tax year by the due date (including extensions) of that return." The Proposed Regulations would add unique rules for Forms 5472 filed by foreign-owned, single-member, domestic DREs, rules that apparently will only be announced by the IRS, later and separately, on Form 5472 or the instructions thereto. If the Proposed Regulations are issued undisturbed, then Reg. §1.6038A-2(d) will say the following. The new language is italicized to facilitate review.

> A Form 5472 required under this section must be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. *In the case of an entity that is treated as a reporting corporation by reason of §301.7701-2(c)(2)(vi) of this chapter, Form 5472 must be filed at such time and in such manner as the Commissioner may prescribe in forms or instructions.*

V. Interesting Issues Concerning Form 5472

Being aware of the potential changes by the Proposed Regulations is important, but that is just the surface. To appreciate the broader implications of the Proposed Regulations, one must examine other items involving Form 5472. Initial questions, comments and observations are set forth below.

A. Late Forms 5472 Now Trigger Automatic Penalties

A relatively obscure aspect of Form 5472 is that the IRS has been *automatically* imposing penalties since 2013. The IRS, after achieving considerable economic success by automatically sanctioning other types of international information returns, decided to implement the so-called systematic assessment mechanism for Forms 5472 in 2013. Since that time, if a Form 1120 or Form 1120-F is filed after the deadline and Forms 5472 are enclosed, then the IRS will assess a $10,000 per-violation penalty and immediately start the collection process, regardless of whether the taxpayer includes with the late Forms 5472 a statement of reasonable cause.[51]

One must review two separate reports by the U.S. Treasury Inspector General for Tax Administration ("TIGTA") to understand how the IRS arrived at this assess-penalties-now-possibly-consider-excuses-later situation. The first TIGTA report was released in 2006.[52] It recognized that Forms 5472, along with Forms 5471 (for controlled foreign corporations), play a fundamental role in promoting international tax compliance. Indeed, according to TIGTA, their importance is reflected "in the severity of the penalties" for filing violations.[53] TIGTA observed in its 2006 report that (i) the IRS should have asserted $79.2 million more in penalties in 2002 alone, (ii) the under-penalization was attributable to the fact that sanctions had historically been asserted by Revenue Agents, manually, only in the limited situations where they detected the noncompliance and (iii) the IRS was "missing opportunities to promote better compliance with the filing requirements for Forms 5471 and 5472 by not assessing the late-filing penalties more often."[54] TIGTA made two main recommendations to the IRS in its 2006 report. First, the IRS should convene a study group to determine whether to "automate" the penalty-assessment process for Form 5471 and Form 5472. Second, the IRS should commence a "pilot program" for automatic assessment of penalties.[55] The IRS agreed with and implemented both suggestions from TIGTA.

The follow-up report was released by TIGTA in 2013.[56] It indicated that one of the biggest issues facing the IRS is accelerating globalization. To help meet the challenges of international tax administration, the IRS has adopted a four-part strategy: (i) Expand employee knowledge and awareness of international tax issues. (ii) Develop deep expertise and capabilities in key international issue areas. (iii) Enhance coordination with foreign treaty partners and international organizations. (iv) Aggressively target areas of significant risk.[57] This, explains the 2013 report from TIGTA, has generated "increased enforcement efforts on international information reporting requirements and increased assessments of related penalties."[58]

Let us talk statistics. The 2013 report confirms that the IRS officially introduced the automated penalty program in 2009 with respect to Forms 5471. Before the program was in place, in 2008, the total penalties were $7.6 million. Once the IRS started automatically imposing late Form 5471 penalties, the figures jumped dramatically: $71.5 million in 2009, $48.6 million in 2010, $54.3 million in 2011 and $41 million in 2012.[59] The 2013 report confirms that, based on this degree of success with Forms 5471, the IRS decided to expand the automated/systematic penalty program to Forms 5472 in January 2013. The TIGTA report makes it clear that the IRS anticipates this new move to be lucrative, as Form 5472 penalties in 2011 alone would have reached approximately $103 million if the automated penalty program had been in place that year.[60] The TIGTA report contained several recommendations, including further expanding the automated penalty program to even more areas starting in 2014. TIGTA also suggested that the IRS decrease the number of abatements granted after the IRS has automatically assessed penalties. One way to achieve this reduction of abatements, said TIGTA, would be to obligate IRS personnel to review and implement the strict rules in the Form 5472 "Decision Tree" discussed later in this article.[61]

B. First-Time Abate Policy Is Narrowly Applied

The good news is that the IRS has a first-time-penalty-abatement policy, and taxpayers facing large Form 5472 penalties often cite this policy in seeking relief.[62] The policy states that the IRS will grant penalty abatement, with respect to virtually all delinquency penalties (including late-filing penalties under Code Sec. 6651, late-payment penalties under Code Sec. 6651 and federal tax deposit penalties under Code Sec. 6665) in situations where a taxpayer has not been required to file a certain return before, or the taxpayer has no prior penalties of this type.[63] If the taxpayer meets these criteria, then the IRS generally issues a letter to the taxpayer containing the following paragraph confirming that abatement is being granted solely on the basis of the first-time-penalty-abatement policy, not because the taxpayer has demonstrated that it had reasonable cause for the violation.

> We are pleased to inform you that your request to remove the (use applicable penalty, *i.e.* failure to file, failure to pay, or failure to deposit) penalty(ies) has been granted. However, this action has been taken based solely on your compliance history rather than on the information you provided. This type of penalty removal is a one-time consideration available only for a first-time penalty charge. IRS will base decisions on removing any future (failure to file, failure to pay, failure to deposit) penalties on any information you provide that meets reasonable cause criteria. You should receive a notice of penalty adjustment within the next few weeks.[64]

The first-time-penalty-abatement policy is bittersweet, as is so often the case with IRS issues. The bad news is that the policy does *not* apply to (i) "returns with an event-based filing requirement," (ii) situations where a taxpayer filed a Form 1120 late for one of the past three years but was not penalized and (iii) "information reporting that is dependent on another filing, such as various forms [like Forms 5472] that are attached [to income tax returns]."[65] Some IRS personnel simply deny requests for waiver of Form 5472 penalties based on these exclusions from the first-time-penalty-abatement policy. More specialized IRS personnel generally apply the four-step process, explained below, which is designed for overlapping penalties involving late Forms 1120 and Form 5472.[66]

- **Step 1.** If the taxpayer seeks abatement of both the delinquency penalties related to Form 1120 and Form 5472 penalties, then the International Department at the IRS Office in Ogden, Utah will first review the issues related to Form 1120.
- **Step 2.** If the related delinquency penalty for the Form 1120 is abated because the taxpayer demonstrates that there was "reasonable cause" for the violation, then Form 5472 penalties should be abated using the same rationale/code.
- **Step 3.** If the delinquency penalty for the Form 1120 is abated not because "reasonable cause" existed, but rather because of the application of the first-time-penalty abatement policy, then Form 5472 penalties can be abated under the same rationale/code, *only if* the IRS has not asserted Form 5472 penalties within the past three years.[67]

- **Step 4.** If the related delinquency penalty for Form 1120 is not abated (*i.e.*, because the first-time-penalty-abatement policy does not apply and there was no reasonable cause for the violation), then IRS personnel must consult the "Failure to File or Late-Filed Form 5472 Decision Tree" to determine whether the Form 5472 can be abated independently of the Form 1120 issue.

Thus, if a penalty issue reaches Step 4, then the IRS must resolve it pursuant to the rules contained in the "Decision Tree." The Internal Revenue Manual expands on the use of the "Decision Tree," indicating that *all* requests by taxpayers for abatement based on reasonable cause must be analyzed in accordance with the terms of the "Decision Tree," if the Form 5472 penalties were automatically assessed by the IRS's computers, as opposed to being assessed by a Revenue Agent conducting an audit.[68]

C. Functioning of the "Decision Tree" for Form 5472 Penalties

If someone does not know the rules of the game, it is terribly unlikely that he or she will triumph. This holds true in the area of penalty disputes with the IRS. Certain taxpayers and tax professionals think that the concept of "reasonable cause" is the same for all tax provisions containing this phrase, including Code Sec. 6038A. This is logical, but incorrect, and it causes problems for those seeking penalty abatement of Form 5472 penalties.

Most Form 5472 penalties must be resolved by IRS personnel *not* by applying the standards contained in other tax provisions (such as accuracy-related penalties under Code Sec. 6662, delinquency penalties under Code Sec. 6651, estimated tax penalties under Code Sec. 6654 and information-return penalties under Code Sec. 6721), and *not* by applying the general standards contained in the IRS's Penalty Handbook and regulations, but rather by applying the "Decision Tree" for Form 5472 penalties. This "Decision Tree," found in the depths of the Internal Revenue Manual, features standards that are much more stringent than those located elsewhere.[69] The following examples, taken directly from the "Decision Tree," demonstrate that attaining abatement of Form 5472 penalties can be significantly more challenging than normal.

- If the taxpayer claims that it was unaware of the Form 5472 filing requirement, the "Decision Tree" instructs the IRS to deny abatement because "ordinary business care and prudence requires taxpayers to determine their tax obligations when establishing a business in a foreign country."
- The "Decision Tree" mandates that penalty abatement be denied where the taxpayer seeks clemency because of financial problems.
- The "Decision Tree" further indicates that the IRS will show no mercy in situations where a taxpayer states that Form 5472 was late because the transactions, tax laws and/or business structure were complicated.
- If the taxpayer claims that multiple layers of ownership prevent the taxpayer from obtaining all the data necessary to file a timely Form 5472, the "Decision Tree" instructs the IRS not to abate penalties.
- Rejection of the penalty abatement request will also occur, according to the "Decision Tree," when the taxpayer relies on challenges in obtaining the necessary foreign data as the excuse for late Forms 5472.
- The "Decision Tree" demands imposition of penalties if the reason for the delinquent Forms 5472 is that the person with sole authority to file Form 5472 was absent for a reason other than death or serious illness. Moreover, even if death or serious illness of the sole responsible person is claimed, the IRS will only accept this justification if (i) the corporation can provide tangible proof, such as an insurance claim, police report, letters or bills from hospitals or newspaper clippings describing the event; (ii) the absence was not foreseeable; (iii) the absence occurred before and in close proximity to the filing deadline; and (iv) the taxpayer filed the Forms 5472 within two weeks of when the absence ended.
- The IRS will not waive Form 5472 penalties under the "Decision Tree" if the taxpayer neglected to file a Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*, to secure an automatic six-month extension to file a Form 1120 or Form 1120-F.
- The "Decision Tree" also denies abatement where the taxpayer hired a third-party (such as an accounting firm) to prepare returns and erroneously believed that such third-party has filed a Form 7004 on behalf of the taxpayer.
- Abatement requests will also be rejected under the "Decision Tree" if the taxpayer relies on the ignorance-of-the-law defense and the taxpayer was a U.S. resident, resided outside the United States but failed to even retain U.S. tax representation, or claims that it was unaware of the obligation to file U.S. tax returns.
- For purposes of seeking penalty abatement, the "Decision Tree" clarifies that reliance on an accountant or attorney might be appropriate in certain situations, but reliance by a taxpayer on the following types of people is not reasonable: Bookkeeper, financial advisor, business associate, information in a tax plan or promotion and person assisting in establishing the corporation.

- Finally, the "Decision Tree" indicates that it might abate penalties based on the reasonable-reliance-on-a-qualified-tax-professional defense if, and only if, the taxpayer relied on an accountant or attorney, the taxpayer provided such tax professional all relevant information, the taxpayer supplied the information before the deadline for filing Form 5472, the tax professional advised the taxpayer that it was not required to file Form 5472, the taxpayer has tangible evidence to prove the preceding facts, and, in the opinion of the IRS, the taxpayer's reliance was reasonable. The "Decision Tree" goes on to state that the taxpayer's reliance will be considered unreasonable (and thus Form 5472 penalties will not be abated) if the taxpayer did not take reasonable steps to independently investigate or the taxpayer did not get a second opinion.

The last aspect of the "Decision Tree" is particularly remarkable because it is contrary to the legal precedent established by the U.S. Supreme Court years ago on this exact point. In a famous tax case from 1985, *R.W. Boyle*, the highest court in the land explained that taxpayers are not required to seek a second opinion as a condition to benefitting from the reasonable-reliance-on-a-qualified-tax-professional defense:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[70]

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D. Effect of Late or Unfiled Forms 5472 on Assessment Periods

The standard penalty of $10,000 per year, per violation can hurt a corporation, but the most significant consequence late/not filing Forms 5472 has nothing to do with money. It concerns time, *i.e.*, the amount of time that the IRS has to audit the relevant issues. An obscure procedural provision, Code Sec. 6501(c)(8)(A), contains a powerful tool for the IRS. It generally states that where a taxpayer fails to file a timely Form 5472 (and/or a long list of other international information returns), the assessment period remains open "with respect to any tax return, event, or period" to which the Form 5472 relates until three years after the taxpayer ultimately files Form 5472.[71] Consequently, if a corporation fails to file Forms 5472 for a particular year or set of years, it is unable to simply run out the clock with the IRS.

For corporations required to enclose Forms 5472 with the Forms 1120 or Forms 1120-F, the threat of Code Sec. 6501(c)(8) is serious; the IRS could assert penalties of $10,000 per Form 5472 violation, the IRS could reach older years that would normally have been closed thanks to the statute of limitations, and the IRS could audit the entire Form 1120 or Form 1120-F with which the Forms 5472 should have been enclosed and then propose tax increases, penalties and interest charges. However, because many of the entities covered by the Proposed Regulations (*i.e.*, foreign-owned, single-member, domestic DREs) have no duty to file income tax returns with the IRS, the hazards created by Code Sec. 6501(c)(8) might be minimal or nonexistent for them.

E. Unresolved Filing Procedures

The Proposed Regulations leave unresolved procedural issues, alluding to future guidance from the IRS. Although not openly stated in the Proposed Regulations, the IRS's indecision about how foreign-owned, single-member, domestic DREs will file Forms 5472 likely is the result of a potential conflict with other procedural/filing rules that the IRS introduced in recent years. Consider the following comparison.

1. Procedures for Corporations under Code Sec. 6038A or Code Sec. 6038C

The IRS issued temporary and proposed regulations in June 2011, modifying the filing rules for real/actual domestic corporations under Code Sec. 6038A and real/actual foreign corporations under Code Sec. 6038C.[72] The modifications, as shown below, consisted of deleting certain language from regulations in effect at that time:

> *Time for Filing Returns*. A Form 5472 required under this section shall be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. ~~A duplicate Form 5472 (including any attachments and schedules) shall be filed at the same time with the Internal Revenue Service Center, Philadelphia, PA 19255. A Form 5472 that is timely filed electronically satisfies the duplicate filing requirement.~~

> *Untimely Filed Return*. If the reporting corporation's income tax return is untimely filed, Form 5472 ~~(with a duplicate to Philadelphia)~~ nonetheless must be timely filed ~~at the service center where the return is due.~~ When the income tax return is ultimately filed, a copy of Form 5472 must be attached.

According to the Preamble to the regulations in June 2011, advances in electronic processing and data-collection generally rendered it unnecessary for a reporting corporation to file copies of Forms 5472 with the IRS Service Center in Philadelphia, regardless of whether the reporting corporation e-filed or paper-filed its Form 1120 or Form 1120-F.[73] The IRS clarified, however, that in situations involving late Forms 1120 or late Forms 1120-F, the reporting corporation would still be required to file timely Forms 5472 by paper with the appropriate IRS Service Center, as there was no avenue for e-filing Forms 5472 separately from Forms 1120 or Forms 1120-F.[74]

No public comments were received and no request for a public hearing was made, so the IRS finalized the preceding regulations in June 2014. In doing so, the IRS confirmed that the "only remaining provision for filing a Form 5472 separately from the filer's income tax return applies to cases in which the filer's income tax return is not timely filed."[75]

At the same time that the IRS finalized the regulations in June 2014, it also issued proposed regulations designed to eliminate the special rules in Reg. §1.6038A-2(e) aimed at late-filed Forms 1120 and Forms 1120-F. These proposed regulations "would require that Form 5472 be filed *in all cases only* with the filer's income tax return for the tax year by the due date (including extensions) of that return."[76] What the IRS proposed, in short, was to completely eliminate the existing guidance regarding what taxpayers must do if they will be filing a late Form 1120 or Form 1120-F.

The IRS's official stance about the simplification of the Form 5472 filing requirements is explained in the Preamble to the proposed regulations in June 2014. The IRS, referencing approximately 30 years of experience with the matter, now believes that the untimely return provision (*i.e.*, Reg. §1.6038A-2(e)) is not conducive to efficient tax administration because it differs from the filing methods and penalty structures applicable to other international information returns, such as Forms 5471 (for controlled foreign corporations) and Forms 8865 (for certain foreign partnerships). Those international information returns must be filed with a taxpayer's income tax return by the relevant due date (including extensions), and there is no separate rule, demanding or permitting the filing of such returns apart from the relevant income tax returns.[77]

The IRS received merely two sets of comments to the proposed regulations from June 2014; it declined to adopt one, and it discounted the other as unresponsive. Ultimately, the IRS adopted the proposed regulations without substantive changes, such that, for tax years ending on or after December 24, 2014, the *only* remaining rule in the Code Sec. 6038A regulations about filing Forms 5472 consisted of Reg. §1.6038A-2(d), in the following form:

> A Form 5472 required under this section shall be filed with the reporting corporation's income tax return [*i.e.*, Form 1120 or Form 1120-F] for the taxable year by the due date (including extensions) of that return.[78]

2. Procedures for Deemed Corporations Under Proposed Regulations

As explained above, the IRS passed a series of regulations over the years, most recently from 2011 through 2014, the effect of which was that real/actual corporations must file Forms 5472 with their Forms 1120 or Forms 1120-F, regardless of whether they are timely or late. The challenge for foreign-owned, single-member, domestic DREs treated as domestic corporations *solely* for purposes of Code Sec. 6038A is that most of these entities are not required to file a U.S. tax return. Consequently, the existing regulations demanding the enclosure of Forms 5472 with annual income tax returns do not work. The IRS seems to have caught this glitch, and then presented the following, updated version of Reg. §1.6038A-2(d) in the Proposed Regulations. The new language is italicized.

> A Form 5472 required under this section must be filed with the reporting corporation's income tax return for the taxable year by the due date (including extensions) of that return. *In the case of an entity that is treated as a reporting corporation by reason of §301.7701-2(c)(2)(vi) of this chapter, Form 5472 must be filed at such time and in such manner as the Commissioner may prescribe in forms or instructions.*

The Proposed Regulations maintain the obligation of real/actual corporations to enclose Forms 5472 with income tax returns, while suggesting that the IRS will issue special guidance for deemed domestic corporations (*i.e.*, foreign-owned, single-member, domestic DREs), which generally have no income tax filing obligation, in future versions of Form 5472 and/or the IRS's Instructions to Form 5472. Many look forward to seeing how the IRS solves this riddle.

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F. First Step of Many Regarding Disclosure of Disregarded Entities

Many more disclosure requirements are on the way, says the IRS. According to the Proposed Regulations, "the IRS is also considering modifications to corporate, partnership, and other tax or information returns (or their instructions) to require the filer of these returns to identify all the foreign and domestic disregarded entities it owns."[79]

G. Uncertain Impact of the Proposed Regulations

As discussed earlier in this article, the IRS and White House have repeatedly stated the importance of expanding the Form 5472 filing and record-keeping obligation, and the Proposed Regulations themselves indicate that they are designed "to provide the IRS with improved access to information that it needs to satisfy obligations under U.S. tax treaties, tax information exchange agreements and similar international agreements, as well as to strengthen the enforcement of U.S. tax laws."[80] Given all the effort, resources and money that the IRS has devoted or will devote to analyzing the issues, drafting the Proposed Regulations, participating in a public hearing, reviewing and incorporating public comments, preparing final regulations, revising relevant IRS documents (*e.g.*, Form 8832, Form SS-4, Form 5472, the IRS's Instructions to each and various tax publications), updating its website, *etc.*, one would think that the problems triggered by the lack of information about certain foreign-owned, single-member, domestic DREs were widespread. However, the IRS denies this in the Preamble to the Proposed Regulations, stating that they "will not have a significant economic impact on a substantial number of small entities [and] will primarily affect a small number of foreign-owned domestic entities that do not themselves otherwise have a U.S. return filing requirement, and that the requirement to file a return for these entities will not impose a significant burden on them."[81] This triggers an obvious question: If only a "small number" of foreign-owned, single-member, domestic DREs will be affected by the Proposed Regulations, then why are high-ranking members of the Treasury and the White House claiming that the Proposed Regulations close "a loophole in U.S. laws that has allowed foreigners to hide assets or financial activities behind anonymous entities," and why are multiple, respectable periodicals calling the United States "the biggest tax haven in the world" and "the new Switzerland?"

H. Proposed Regulations Mean Nothing

One must keep in mind that the Proposed Regulations are, from a legal perspective, just suggestions. Courts have long held that proposed regulations are entitled to essentially no judicial deference. For example, in *J.C. Zinniel*,[82] the Tax Court explained the following:

> [P]roposed regulations are merely suggestions made for comment. Proposed regulations "carry no more weight than a position advanced on brief by the respondent." If [the IRS] wanted these sections of the regulations to carry more weight than a position advanced on brief, [the IRS] could have issued them as temporary regulations. Thus, we hold that the proposed regulations cited by the parties do not have the force of law, and therefore are not determinative on the issue ...

The Tax Court's holding in *Zinniel* was an acknowledgment of the longstanding law regarding the ineffectiveness of proposed regulations. The following survey of cases confirms that proposed regulations lack legal authority.

- *A.G. Laglia*[83] ("First, we note that although final regulations command our respect, proposed regulations carry no more weight than a position advanced on brief by [the IRS].").
- *C.A. Scott*[84] ("[W]e are dealing with a proposed regulation. As such, it does not reflect the views of the [IRS] following a reconsideration of [its] proposed rules as a result of an administrative hearing and comments that may have been submitted by interested persons.").
- *LeCroy Research Systems Corp.*[85] ("Proposed regulations are suggestions made for comment; they modify nothing.").
- *F.W. Woolworth Co.*[86] ("These proposed regulations have not as yet been formally adopted. Consequently, they carry not more weight than a position advanced on brief by the [IRS].").
- *KTA-Tator, Inc.*[87] ("While proposed regulations do constitute 'a body of informed judgment * * * which courts may draw on for guidance,' we accord them no more weight than a litigation position.").
- *Hospital Corp. of America*[88] ("We recognize that the proposed regulations 'carry no more weight than a position advanced on brief by the [IRS].'").
- *F.J. Tedori*[89] ("[T]hose 'proposed regulations carry no more weight than a position advanced on brief.'").
- *Natomas North America*[90] ("Proposed regulations are not entitled to judicial deference. Proposed regulations 'carry no more weight than a position advanced on brief by the [IRS].'").
- *Republic Plaza Prop. P'ship.*[91] ("Those proposed regulations ... are not in any event binding on the Court ...").
- *R.R. Mearkle*[92] ("[W]hen discussing the degree of deference courts should accord a regulation which has

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incorporated the position of an agency, proposed regulations are not entitled to the same deference as are final regulations. In the instance of a proposed regulation, the promulgating agency has not had the benefit of administrative hearings or of comments from interested persons concerning the advisability of modifying the proposed regulation or adopting it as final.").

- *Southland Royalty Co.*[93] ("The court notes that the proposed regulations were never adopted and thus do not constitute controlling authority. Any reliance by plaintiff on the proposed regulations is misplaced.").

VI. Conclusion

Assuming that the Proposed Regulations are adopted in their current form or close thereto, there are three probable consequences: (i) The practice of using foreign-owned, single-member, domestic DREs to conceal funds will decline or disappear. (ii) Foreign taxpayers will intentionally disregard the Form 5472 duty, valuing nondisclosure over the possibility of detection and enforcement by the IRS. (iii) Foreign taxpayers and their advisors will inadvertently violate the Form 5472 filing and record-keeping obligations, thereby triggering audits, penalties and disputes. Regardless of the outcome, all taxpayers potentially subject to Form 5472 duties (*i.e.*, domestic corporations that are least 25-percent foreign-owned, foreign corporations operating a U.S. trade or business, and, soon, foreign-owned, single-member, domestic DREs) should retain specialized U.S. tax professionals to advise on these complex, dynamic issues.

ENDNOTES

[1] Act Sec. 339(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248).
[2] U.S. Joint Committee on Taxation. General Explanation of the Tax Equity and Fiscal Responsibility Act of 1982. JCS-38-82 (Dec. 31, 1982), at 250.
[3] Act Sec. 7403 of the Omnibus Budget Reconciliation Act of 1989 (P.L. 101-239).
[4] Act Sec. 11315 of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508).
[5] Code Sec. 6038A(a); Reg. §1.6038A-1(c)(1).
[6] Code Sec. 6038A(c)(1); Reg. §1.6038A-1(c)(2),(3).
[7] Reg. §1.6038A-1(f).
[8] Code Sec. 6038C(a); Reg. §1.6038A-1(c)(1).
[9] Reg. §1.6038A-1(c)(5)(i).
[10] Reg. §1.6038A-2(a)(2); Reg. §1.6038A-2(b)(3); Reg. §1.6038A-2(b)(4); Reg. §1.6038A-2(b)(5).
[11] Reg. §1.6038A-2(a)(2). There are also special attribution rules applicable to "reportable transactions" in which either a domestic partnership or foreign partnership engages, and the ownership interest in the partnership by the "reporting corporation" is deemed to reach 25 percent or more. These complex, special rules exceed the scope of this article. ***See*** Reg. §1.6038A-1(e)(2); Reg. §1.6038A-2(g).
[12] Code Sec. 6038A(c)(2); Reg. §1.6038A-1(d). For purposes of determining whether a domestic corporation is considered a "reporting corporation" because it has a 25-percent-foreign-shareholder and whether a person is considered a "related party," the regulations modify the constructive ownership rules of Section 318, further complicating the analysis. ***See*** Reg. §1.6038A-1(e)(1).
[13] Reg. §1.6038A-1(d)(3).
[14] Reg. §1.6038A-2(a)(1). The regulations contain various exceptions whereby a reporting corporation is not required to file a Form 5472. ***See*** Reg. §1.6038A-2(f).
[15] Reg. §1.6038A-2(a)(1).
[16] Code Sec. 6038A(a); Reg. §1.6038A-3(a).
[17] Reg. §1.6038A-3(g) and (f).
[18] Reg. §1.6038A-1(h) and (i).
[19] Reg. §1.6038A-1(h) and (i). The regulations clarify that "[s]uch a corporation, however, remains subject to the information reporting requirements of Treas. Reg. §1.6038A-2 and the general record maintenance requirements of Section 6001."
[20] Code Sec. 6038A(d)(1); Reg. §1.6038A-4(a)(1).
[21] Reg. §1.6038A-4(a)(1). This regulation states that "[t]he filing of a substantially incomplete Form 5472 constitutes a failure to file Form 5472."
[22] Code Sec. 6038A(d)(1); Reg. §1.6038A-4.
[23] Code Sec. 6038A(d)(2); Reg. §1.6038A-4(d)(1); Reg. §1.6038A-4(f), Example 1.
[24] Code Sec. 6038A(d)(3); Reg. §1.6038A-4(b)(1).
[25] Reg. §1.6038A-4(b)(2)(i).
[26] Reg. §1.6038A-4(b)(2)(iii).
[27] Reg. §1.6038A-4(b)(2)(iii).
[28] Reg. §1.6038A-4(b)(2)(i).
[29] T.D. 8040, 1985-2 CB 291, 50 FR 30160-01 (July 24, 1985), Preamble.
[30] Reg. §1.6038A-2(b)(6)(i).
[31] Reg. §1.6038A-2(b)(6)(ii).
[32] Reg. §1.6038A-2(b)(7).
[33] Reg. §1.6038A-4(b)(2)(ii).
[34] Form 8832 (Rev. December 2013), Specific Instructions, at 6.
[35] IRS Instructions for Form SS-4 (Rev. February 2016), at 3.
[36] Form 8832 (Rev. December 2013), General Instructions, at 4.
[37] IRS Instructions for Form SS-4 (Rev. February 2016), at 4.
[38] REG-127199-15 (May 6, 2016), Preamble.
[39] Ryan Finley, *New Regs Will Force Foreign-Owned Single-Member LLCs to Report Beneficial Owner*, 2016 Worldwide Tax Daily 63-1 (2016); *The Biggest Loophole of All*, The Economist, ___ (2016); Robert W. Woods, *The World's Next Top Tax Haven Is … America*, Forbes ___ (2016); Jesse Drucker, *The World's Favorite New Tax Haven Is the United States*, Bloomberg Businessweek ___ (2016); John Dizard. Fear and Regulatory Loathing Makes America the Top Tax Haven, Financial Times ___ (2016).
[40] *Id.*
[41] PriceWaterhouseCoopers, LLP, *Disregarded Entity Regs Could Lead to Large Penalties, PWC Says*, 2016 Tax Notes Today 114–137 (2016).
[42] REG-127199-15 (May 6, 2016), Preamble.
[43] REG-127199-15 (May 6, 2016), Preamble. The Preamble notes, though, that the IRS is seeking comments on possible "alternative methods" for reporting transactions in cases of duplication.
[44] *White House Proposes Requiring EINs for Disregarded Entities*, 2016 Tax Notes Today 89–159 (2016). This language is part of the *Fact Sheet: Obama Administration Announces Steps to Strengthen Financial Transparency, and Combat Money Laundering, Corruption, and Tax Evasion*. ***See also*** *Lew Urges Congress to Pass Tax Treaties, Transparency Bill*," 2016 Tax Notes Today 89–157 (2016).
[45] Reg. §301.7701-3(a).
[46] Reg. §301.7701-3(b)(1)(ii).
[47] Proposed Reg. §301.7701-2(c)(2)(vi)(A).
[48] Proposed Reg. §301.7701-2(c)(2)(vi)(B)(1).
[49] Code Sec. 6038A(a); Reg. §1.6038A-3(a).
[50] Reg. §1.6038A-3(g) and (f).
[51] IRM §21.8.2.20.1 (Oct. 1, 2014).
[52] U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006).

[53] U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006), at 1–2.

[54] U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006), at 2.

[55] U.S. Treasury Inspector General for Tax Administration. Automating the Penalty-Setting Process for Information Returns Related to Foreign Operations and Transactions Shows Promise, but More Work Is Needed. Report 2006-30-075 (May 2006), at 7–8.

[56] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013).

[57] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 1.

[58] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 1.

[59] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 2.

[60] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 5.

[61] U.S. Treasury Inspector General for Tax Administration. Systematic Penalties on Late-Filed Forms Related to Certain Foreign Corporations Were Properly Assessed, but the Abatement Process Needs Improvement. Report 2013-30-111 (Sept. 25, 2013), at 8.

[62] IRM §20.1.3.6.1(7) (Aug. 5, 2014).

[63] IRM §20.1.3.6.1(7) (Aug. 5, 2014).

[64] IRM §20.1.3.6.1(7) (Aug. 5, 2014).

[65] IRM §20.1.3.6.1(8) and (9) (Aug. 5, 2014).

[66] IRM §21.8.2.20.2 (Oct. 1, 2014).

[67] IRM §21.8.2.20.2(2) (Oct. 1, 2014).

[68] IRM §21.8.2.20.2(3) and (4) (Oct. 1, 2014).

[69] I.R.M. Exhibit 21.8.2-2—Failure to File or Late-Filed Form 5472—Decision Tree.

[70] *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 251, 105 SCt 687 (emphasis added).

[71] Code Sec. 6501(c)(8)(B) contains a limitation, stating that the assessment period will open remain only with respect to "the item or items" related to the late Form 5472 if the taxpayer can demonstrate that the delinquency was due to reasonable cause and not due to willful neglect.

[72] T.D. 9529, IRB 2011-30, 57, and REG-101352-11. The regulations modify the general filing rule in Reg. §1.6038A-2(d) and the special rule for late returns in Reg. §1.6038A-2(e).

[73] T.D. 9529, IRB 2011-30, 57, Preamble.

[74] T.D. 9529, IRB 2011-30, 57, Preamble.

[75] T.D. 9667, IRB 2014-26, 1107.

[76] REG-114942-14.

[77] REG-114942-14, Preamble.

[78] T.D. 9707, IRB 2015-2, 247.

[79] REG-114942-14, Preamble.

[80] REG-127199-15 (May 6, 2016), Preamble.

[81] REG-127199-15 (May 6, 2016), Preamble—Special Analyses.

[82] *J.C. Zinniel*, 89 TC 357, 369, Dec. 44,146 (1987).

[83] *A.G. Laglia*, 88 TC 894, 897, Dec. 43,838 (1987).

[84] *C.A. Scott*, 84 TC 683, 690, Dec. 42,024 (1985).

[85] *LeCroy Research Systems Corp.*, CA-2, 85-1 USTC ¶9107, 751 F2d 123, 127.

[86] *F.W. Woolworth Co.*, 54 TC 1233, 1265–1266, Dec. 30,169 (1970).

[87] *KTA-Tator, Inc.*, 108 TC 100, Dec. 51,931 (1997).

[88] *Hospital Corp. of America*, 109 TC 21, n.40, Dec. 52,163 (1997).

[89] *F.J. Tedori*, CA-9, 2000-1 USTC ¶50,433, 211 F3d 488, 492

[90] *Natomas North America*, 90 TC 710, n.11, Dec. 44,700 (1988).

[91] *Republic Plaza Prop. P'ship.*, 107 TC 94, n.15, Dec. 51,546 (1996).

[92] *R.R. Mearkle*, CA-6, 88-1 USTC ¶9181, 838 F2d 880, 883.

[93] *Southland Royalty Co.*, CtCls, 91-1 USTC ¶50,083, 22 ClsCt 525, n.13 (1991).

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